No. 73-641

In the Supreme Court of the United States

OCTOBER TERM, 1973

EDWIN A. SNOW AND HELEN B. SNOW,
PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT

MEMORANDUM FOR THE RESPONDENT IN OPPOSITION

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The sole question presented in this federal income tax case is whether petitioners were entitled to deduct a pro rata share of amounts claimed by their partnership as research and development expenditures under Section 174 of the Internal Revenue Code of 1954. Both courts below held that the expenditures in question were not deductible because they were not incurred in connection with a "trade or business."

1. Petitioner[1] was an executive vice president and member of the board of directors of Proctor & Gamble

[1] References to petitioner are to Edwin A. Snow only. Helen B. Snow is included as a petitioner solely because she filed a joint income tax return with her husband for the taxable year in issue.

Company. In 1966, he invested $10,000 for a four percent interest in a limited partnership known as Burns Investment Company, which had been organized to assist in financing the development of a trash burning device (Pet. App. 14, 20-21). Petitioner and two other limited partners supplied the financing; development of the invention was to be performed by the general partner (Pet. App. 23).

In 1966, Burns Investment Company had no manufacturing plant, no office or separate facility, no separate telephone, and no sign on the premises it shared with another partnership. During that year most of the funds contributed by the limited partners were exhausted, and thereafter the general partner financed the further development of the device. The partnership did not file a patent application until June 10, 1968, and no patent was issued until March 3, 1970. A corporation was subsequently organized to produce and market the device (Pet. App. 23). During 1966, petitioner devoted at least 50 hours per week to his Proctor & Gamble employment, an additional three to four hours to a race horse operation, and another hour to a joint venture oil operation. He devoted some time to meetings and conversations with the inventor about the trash burner and witnessed some tests on models of the device (Pet. App. 26).

The partnership filed a partnership return for the taxable period August 1, 1966 through December 31, 1966, showing capital as of August 1 to be $40,000, claiming research and development expenses of $36,780.44, and reflecting no income. It thereby showed a loss of $36,780.44, which the company elected "to expense in the current taxable year" as Section 174 research and development expenses (Pet. App. 24). Petitioner reported his share, $9,195.11, as a partnership loss

deduction on his income tax return for 1966 (Pet. App. 24, 25-26). On audit, the Commissioner of Internal Revenue disallowed the deduction on the ground that neither petitioner nor the partnership met the "trade or business" requirement of Section 174. The Tax Court sustained the Commissioner's determination (Pet. App. 26-34), and the court of appeals affirmed (Pet App. 35-44).

2. Section 174 of the Internal Revenue Code provides that "[a] taxpayer may treat research or experimental expenditures which are paid or incurred by him * * * in connection with his trade or business as expenses which are not chargeable to captial account. The expenditures so treated shall be allowed as a deduction."

The judicial decisions interpreting this provision and the Treasury Regulations uniformly require that a taxpayer must be engaged in a trade or business in order to qualify for a research and development expenditure deduction. Treasury Regulations on Income Tax (1954 Code), §§1.174-1 and 1.174-2; *Stanton* v. *Commissioner,* 399 F. 2d 326 (C.A. 5); *Mayrath* v. *Commissioner,* 357 F. 2d 209 (C.A. 5), affirming 41 T.C. 582; *Koons* v. *Commissioner,* 35 T.C. 1092.

The term "trade or business" has a single meaning in all sections of the Code, *Cooper Tire & Rubber Co. Employees' Retirement Fund* v. *Commissioner,* 36 T.C. 96, affirmed *per curiam,* 306 F. 2d 20 (C.A. 6), and this Court has defined it, for purposes of other tax statutes, as "holding one's self out to others as engaged in the selling of goods and services." *Deputy* v. *DuPont,* 308 U.S. 488, 499. It has further held that the question whether a trade or business exists is one of fact. *Higgins* v. *Commissioner,* 312 U.S. 212. Qualification as a "trade or business" activity requires the existence of a genuine

profit motive (*Lamont* v. *Commissioner*, 339 F. 2d 377 (C.A. 2); *Mercer* v. *Commissioner*, 376 F. 2d 708, 711 (C.A. 9)), and that the activities involved be extensive, varied, continuous, frequent and regular (*Austin* v. *Commissioner*, 298 F. 2d 583 (C.A. 2); *Wright* v. *Commissioner*, 274 F. 2d 883 (C.A. 6); *Miller* v. *Commissioner*, 102 F. 2d 476 (C.A. 9)).

In light of this standard, the holding of both courts below that petitioner did not incur the expenditures at issue in connection with his trade or business is amply justified by the undisputed facts. During the year in question, the partnership, in which petitioner was merely an investor, was not holding itself out to others as engaged in the selling of goods and services. Its research and experimentation was not related to the development or improvement of existing products or new products developed in connection with an existing trade or business. Cf. *Best Universal Lock Co., Inc.* v. *Commissioner*, 45 T.C. 1.

Moreover, the legislative history accompanying the enactment of Section 174 demonstrates that it was designed to permit a taxpayer to deduct research and experimental expenditures incurred "in connection with his trade or business" without regard to the "ordinary and necessary" standard. See H. Rep. No. 1337, 83d Cong., 2d Sess., p. 28; S. Rep. No. 1622, 83d Cong., 2d Sess., p. 33.[2] This legislative policy explains the use

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[2] Congressman Reed of New York, Chairman of the Ways and Means Committee, emphasized this purpose during House debate on the measure when he stated that the imposition of the "ordinary and necessary" standard led often to uncertainty regarding the deductibility of such expenses, especially by "small businesses which are developing new products and do not have established research departments." 100 Cong. Rec. 3425.

of the term "not chargeable to capital account." The extraordinary or nonrecurring nature of these designated expenditures will not foreclose their current deductibility. Thus, the aim of Section 174 was to equalize the treatment of small businesses vis-a-vis large businesses and not, as petitioner asserts (Pet. 9-12), to extend the deduction to mere investors who cannot meet the "trade or business" qualification.

3. The decision below does not, as petitioner urges (Pet. 6-8), conflict with *Cleveland* v. *Commissioner,* 297 F. 2d 169 (C.A. 4). There, the taxpayer, a lawyer, had made extensive loans over a long period of time to an inventor who, for over ten years, had experimented with the invention of an inorganic liquid binding material and had applied for patents. After having made a number of advances, taxpayer entered into a trust agreement with the inventor regarding their respective interests in the compound. The Tax Court disallowed a claimed Section 174 deduction for the advances, holding that the arrangement constituted, at most, a sale by the inventor to the taxpayer of a one-half interest in the invention in consideration of past monies advanced, and that the expenditures were not made in taxpayer's trade or business. The court of appeals, however, reversed and allowed the Section 174 deduction with respect to the post-agreement advances. It characterized the agreement as creating a joint venture which it held to be a "trade or business" of the taxpayer.

Allowance of the deduction in *Cleveland* was based upon the particular facts of the taxpayer's active role in the enterprise as a business and legal advisor and negotiator as well as financier, the length of time the inventor had been engaged in his work on the binding material, and its advanced stage of development. Under

these circumstances, none of which were present in this case, the court concluded that the post-agreement expenditures were incurred in the taxpayer's "trade or business."

Moreover, unlike the decision below, the *Cleveland* opinion did not rest upon a definition of the term "trade or business." Subsequent to *Cleveland,* the Fourth Circuit decided *Richmond Television Corp.* v. *United States,* 345 F. 2d 901, relied upon by the court below, which construed the language "carrying on any trade or business" in the context of Section 162(a). There, the Fourth Circuit addressed the question of the definition of "trade or business." It held that even though a taxpayer has made a firm decision to enter into business and spends money over a considerable period of time in preparation for entering that business, he has still not engaged in carrying on a trade or business until the business begins to function as a going concern which performs those activities for which it was organized. Significantly, the court indicated that this definition was equally applicable to Section 174(a)(1) (345 F. 2d at 907, n. 7).

Accordingly, petitioner's enterprise, which had no plant, no separate office or facility, no telephone and no marketing activity during the year in question, did not meet the accepted definition of a "trade or business."

For the reasons stated, it is respectfully submitted that the petition for a writ of certiorari should be denied.

ROBERT H. BORK,
Solicitor General.

DECEMBER 1973.